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CHARLES ELMORE CROPLEY

No. ~~948~~ 24

In the Supreme Court of the United States

OCTOBER TERM, 1941

MARINE HARBOR PROPERTIES, INC., PETITIONER

v.

MANUFACTURERS TRUST COMPANY, AS TRUSTEE; MAURICE RUBINGER, TRUSTEE OF MARINE HARBOR PROPERTIES, INC., ET AL.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

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MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission became a party in the District Court to the present proceeding for the reorganization of Marine Harbor Properties, Inc., under Chapter X of the Bankruptcy Act.[1] The Commission also participated as an appellee in the proceedings before the Circuit Court of Appeals, and the petition for a writ of

[1] The Commission became a party pursuant to the provisions of Section 208 of the Bankruptcy Act (11 U. S. C., Sec. 608).

certiorari filed by the Debtor names the Commission as a respondent.

The Commission is in doubt, however, whether it should properly be regarded as a respondent before this Court, since it has consistently supported the position taken by the petitioner and must therefore be considered as aligned in interest with the petitioner. If the Commission is properly to be considered as a respondent, we ask the Court to regard this memorandum as a memorandum for the respondent Commission joining in the petition for certiorari. If the Commission is not properly to be regarded as a respondent, we ask the Court to regard this memorandum as a memorandum for the Commission, as *amicus curiae*, in support of the petition.[2]

OPINIONS BELOW

The opinions of the Circuit Court of Appeals (R. 107–126) are not yet reported. The opinion of the District Court (R. 70–75) is reported in 41 F. Supp. 814.

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[2] The Commission is not filing a separate petition for certiorari because that would raise an issue as to whether the Commission, which under Section 208 of the Bankruptcy Act may not take an appeal to the circuit courts of appeals, may nevertheless file a petition for a writ of certiorari to review an adverse decision of a circuit court of appeals in a case where the Commission was an appellee in the circuit court of appeals. It seems preferable that the clear-cut issue in the present case not be confused by this extraneous issue.

JURISDICTION

The decree of the Circuit Court of Appeals was entered on January 27, 1942 (R. 126). The petition for a writ of certiorari was filed on February 13, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Section 141 of the Bankruptcy Act provides that a petition filed by a debtor under Chapter X shall be dismissed if not filed in good faith, and Section 146 (4) provides that a petition shall be deemed not to be filed in good faith if "a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding." The question presented is whether, under these provisions, a bankruptcy court must relinquish the jurisdiction conferred upon it by Chapter X in favor of a pending state court reorganization proceeding upon a mere showing that the debtor company, which filed the petition under Chapter X, once consented to a plan in the state court proceedings for an extension of a mortgage on its property, and without any showing that the interests of the debtor's creditors and stockholders would be better safeguarded in the state court proceeding than in proceedings under Chapter X.

STATUTE INVOLVED

Section 141 of the Bankruptcy Act (11 U. S. C., Sec. 541) provides as follows:

> Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 146 of the Bankruptcy Act (11 U. S. C., Sec. 546) provides in part as follows:

> Without limiting the generality of the meaning of the term "good faith," a petition shall be deemed not to be filed in good faith if—* * * (4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

STATEMENT

The relevant facts are set forth in the Debtor's petition (pp. 4–6) and need not be repeated here.

ARGUMENT

1. In Chapter X of the Bankruptcy Act, the Congress exercised its paramount bankruptcy power to provide a procedure for the reorganization of distressed corporations. However, in order to assure that this procedure would not be used to defeat rather than to accomplish the congressional objective of protecting security holders, Congress provided in Section 141 that the Dis-

trict Courts are not to assume jurisdiction of a debtor's petition under Chapter X if it is not filed in good faith, and in Section 146 (4) that a petition shall be deemed not to be filed in good faith where a prior proceeding is pending in another court "and it appears that the interests of the creditors and stockholders would be best subserved in such prior proceedings."

In the present case, and in other similar cases as well,[3] the court below ruled that these provisions of the Act require the district courts to dismiss all petitions filed by a debtor company whenever it is shown that the debtor actively participated in prior state court proceedings, irrespective of whether the prior proceedings provide safeguards for public investors comparable to those found in Chapter X. This construction of the Act, with its emphasis upon an assumed personal disqualification on the part of the debtor and its disregard of the interests of the debtor's creditors and stockholders, is, we believe, contrary to both the clear terms and the obvious purpose of the statute; even more important, it serves to deprive the security holders of a large

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[3] *Brooklyn Trust Co.* v. *Rembaugh*, 110 F. (2d) 838; *In re Paloma Estates, Inc.*, decided February 21, 1942, after the petition in this case was filed. Judge Clark, dissenting in the *Paloma* case, referred with approval to the dissent of Judge Frank in the present case. For the convenience of the Court the opinions in the *Paloma* case are printed in the Appendix, *infra*, pp. 15–23.

and important class of corporations of the protection which Congress quite evidently intended to confer upon them by the enactment of Chapter X. Accordingly, the decision seems plainly to call for review by this Court.

2. The Court has recently had occasion to examine the entire structure of Chapter X. *Securities and Exchange Commission* v. *U. S. Realty & Improvement Co.*, 310 U. S. 434. As was there observed, Chapter X provides an integrated and carefully fashioned procedure for the reorganization of corporations and for the protection of their security holders. Provision is made, *inter alia*, for "control by the court over security holders' committees and the formulation of reorganization plans" (310 U. S. 449); for securing "impartial and expert administrative assistance" through participation in the proceedings by the Securities and Exchange Commission (*ibid.*); for the appointment of a disinterested trustee and for an investigation and report by such trustee concerning the debtor's financial problems and management; and for assuring that security holders will not be required to vote on any proposed plan of reorganization until they have received full information concerning the plan and until the plan has been initially approved by the court.

This procedure, as Section 256 of Chapter X makes clear, is to supersede all conflicting state procedures except, as stated in Section 146 (4), where a prior state court proceeding is pending and

the interests of creditors and stockholders would be best subserved in such prior proceedings. The mere pendency of prior state court proceedings is immaterial; they must be of such character or have proceeded to such a point that the security holders would be harmed rather than helped by calling the remedial provisions of Chapter X into play.

The court below disregarded this statutory standard. It undertook to direct dismissal of the petition, not because of the character of the prior state court proceeding, but because of an asserted "lack of good faith flowing from the personal disqualification of the debtor" (R. 111). It is not clear whether this result was thought to follow from the general provision of Section 141, requiring dismissal of all debtors' petitions not filed in good faith, or from the specific provision of Section 146 (4), requiring the dismissal of a debtor's petition where a prior proceeding is pending in which the interests of the security holders would be better subserved than under Chapter X. The court said that there was no "absence of good faith * * * in the broad meaning of those words," and yet, in the next sentence, stated that the special circumstances set forth in Section 146 (4) are "not to be confused with what controls here" (R. 111). Whichever provision the court may have thought applicable, however, we believe its decision to be clearly erroneous.

3. The alleged "personal disqualification of the debtor," the court said, arose because the Debtor

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had once consented to an extension of the mortgage on its properties approved by the state court and had failed to apply to the state court for further relief after the extension expired. Whether the Debtor had the power itself to present an application to the state court for further relief is a question on which the majority of the court below and the District Judge were in disagreement (see R. 110, 71–72, 74–75; see also dissenting opinion of Judge Clark in the *Paloma* case, Appendix, *infra*, p. 22). But whether or not the Debtor might have had recourse to the state court, its failure to do so and the exercise of its statutory right to file a petition under the Bankruptcy Act do not constitute bad faith. As this Court has held in a proceeding under Section 75 (s) of the Bankruptcy Act, a debtor should not be charged with bad faith because he takes the course provided for him by Congress. *John Hancock Mutual Life Insurance Co.* v. *Bartels*, 308 U. S. 180, 185. And, as the court below held in a case involving Chapter XI of the Bankruptcy Act, in answer to the contention that the proceeding had been filed to avoid a state fraud receivership, "the answer is that the debtor has a legal right to have her property administered in bankruptcy." *In re Koch*, 116 F. (2d) 243, 247.

Moreover, the assumption that the personal bad faith of the debtor, if deemed to exist, is relevant to the propriety of the exercise of juris-

diction by the bankruptcy court ignores the essential elements of the statutory scheme devised by Congress. Congress provided the safeguards of Chapter X for the benefit of *investors*; it directed that consideration be given to the interests of *creditors* and *stockholders*. To ignore the real parties in interest and to attach weight to the conduct of the fictional legal entity known as the debtor is to nullify the purposes of the Act. The motives of the debtor itself are unimportant, because once the petition is filed the court, not the debtor, has control of the proceedings. See *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, 125–126. Under the rule enunciated in that case the debtor and its stockholders can gain no strategic advantage from the pendency of the proceedings and their interests will be entirely eliminated unless a surplus remains after payment of all creditors in full (*id.*, 131). Indeed, the more questionable may be the motives of the debtor or the persons controlling it, the more reason there is for the court to take jurisdiction and to make available to creditors and stockholders the safeguards of Chapter X.

4. Had the court below directed its attention, not to the alleged "personal disqualification" of the debtor, but to the effect of the dismissal of the petition upon the interests of the creditors and stockholders, its decision would necessarily have been different.

The prior proceeding has been conducted under the so-called Schackno and Mortgage Commission Acts of New York,[4] which lack almost all the basic safeguards for the protection of securityholders provided by Congress in Chapter X. There is no searching investigation of the debtor's past management and of its present business and prospects which is required through the medium of an independent trustee under Section 167 of the Bankruptcy Act. There is no provision similar to that requiring participation in Chapter X reorganization proceeding by the Securities and Exchange Commission.[5] There is no requirement that a plan must receive preliminary approval by the court before the assent of securityholders may be obtained (cf. Section 176 of the Bankruptcy Act) or that information must be furnished to securityholders (cf. Section 175 of the Bankruptcy Act); and there are no protective provisions as to the form of reorganization (cf. Section 216 of the

[4] L. 1933, c. 745 as amended, N. Y. Unconsolidated Laws, § 1796 *et seq.*; L. 1935, c. 19 as amended, N. Y. Unconsolidated Laws, § 1751 *et seq.*

[5] It is true that the court having jurisdiction of the state court proceedings in the county in which the state court proceedings in this case are pending has established an organization known as the Bureau of Trust Supervision. There is nothing to show, however, that this Bureau has facilities similar to those of the Securities and Exchange Commission for providing advice to the court or a record of achievement in that field.

Bankruptcy Act). Indeed, Chapter X has the same superiorities over the state court procedure as this Court held that it has over the procedure provided in Chapter XI of the Bankruptcy Act. See *Securities and Exchange Commission* v. *U. S. Realty & Improvement Co., supra.*[6]

Nor can there be any contention that the particular proceeding here involved had proceeded to such a point that the maintenance of the Chapter X petition would have been adverse to the interests of investors. To be sure, a "plan" had been approved by the state court in December 1934, but this "plan" merely provided for an extension of the mortgage and the extension expired in 1937 (R. 52, 45). A modification of the plan was approved in 1938; this modification, however, merely established a trustee to act for security holders, without effecting any adjustments of the rights of the certificate holders *vis a vis* the Debtor (R. 38, 22). In the modified plan the state court retained jurisdiction to consider further applications for relief (R. 44), but no such applications were filed.[7] Negotiations between the trustee and the Debtor were un-

[6] See Note (1934) 34 Col. L. Rev. 663; Note (1935) 35 Col. L. Rev. 874; Note (1941) 18 N. Y. U. L. Q. Rev. 399, 418; Siegel, *Chapter X or Schackno Act Proceedings?* (1941) 27 Corn. L. Q. 56.

[7] The Debtor clearly assumed that the reservation of jurisdiction did not empower it to make such an application (R. 62, 67–68).

dertaken but proved futile (R. 14). Thereafter the Debtor defaulted in the payment of interest due April 1, 1941 (R. 12). Since the Schackno Act proceeding gave the creditors no remedy for such default, foreclosure proceedings were commenced and a receiver was appointed to take possession of the Debtor's properties (R. 12–13). Subsequently, negotiations for further extension and modification of the mortgage were undertaken, but they again proved unsuccessful (R. 14). The proceedings having reached this point, unless liquidation through foreclosure sale to an outsider occurs, a new plan must be adopted. No such plan had been promulgated in the foreclosure proceeding at the time the petition under Chapter X was filed.

It seems evident, therefore, that neither the provisions of the statute pursuant to which the state court proceedings were brought, nor the actual history of those proceedings, furnishes any ground for holding the interests of creditors and stockholders would be best served by the dismissal of the Chapter X proceeding.

5. The importance of the issue involved in this case is manifest. Thousands of certificated mortgage issues are being "reorganized" in the state courts, and many of these "reorganizations" have taken the form, as in the present case, of a short extension of the maturity of the mortgage. As

these extensions expire, further "reorganization" is needed. The decision in the present case will, to a large extent, determine whether the federal procedure provided by Chapter X shall be available for such further reorganization.

It is no answer to say that the court below only held the Debtor disqualified to file a petition under Chapter X and that, despite this decision, the federal remedy may be invoked by a petition filed by three security holders having claims aggregating at least $5,000. As Judge Frank pointed out in his dissenting opinion, such security holders are generally ignorant of their theoretical rights and consequently "seldom exercise them, but, instead, usually go along with whatever proceedings have already been instituted" (R. 120). Indeed, as Judge Frank further pointed out (*id.*), it was precisely such inertia on the part of security holders which led to the enactment of many of the provisions of Chapter X.[8]

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[8] The fact that resort has been had to the federal procedure in only a few cases thus far does not indicate that the persons concerned do not choose to resort to it. It would seem rather to indicate that the line of decisions in the Circuit Court of Appeals for the Second Circuit, begun in *Brooklyn Trust Co.* v. *Rembaugh*, 110 F. (2d) 838, and *In re Blinrig Realty Corp.*, 114 F. (2d) 100 (both decided early in 1940), and continued in the present case, and *In re Paloma Estates, Inc.* (*infra*, pp. 15–23), has discouraged any extensive resort to Chapter X.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1942.

APPENDIX

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 152—October Term, 1941.

(Argued January 8, 1942. Decided February 21, 1942.)

In the Matter
—of—
PALOMA ESTATES, INC.,
Debtor-Appellant.

SERIES C-2 TRUSTEES AND SECURITIES AND EXCHANGE COMMISSION,
Appellees.

CHASE, *Circuit Judge:*

The debtor, which owns, subject to a first and to a second mortgage, an apartment house and lot at 200 West 86th Street in the City of New York, filed its petition for reorganization in the District Court for the Southern District of New York under Chapter X of the Bankruptcy Act. The

judge, holding that the petition was not filed in good faith within § 146 (4) of Chapter X, and also that the debtor had not complied with the general good-faith requirement of our decisions in *Brooklyn Trust Company* v. *Rembaugh*, 110 F. (2) 838, and *In re Blinrig Corp.*, 114 F. (2) 100, dismissed the petition. The debtor has appealed and is supported by the Securities and Exchange Commission, which, at the request of the judge, filed its notice of appearance and became an intervening party to the proceedings as provided by § 208 of the Bankruptcy Act. It has filed a brief in this court and has been heard on the oral argument. Other parties are permanent trustees appointed by the state court, for holders of certificates under the first mortgage and who have appeared to contest this appeal; the second mortgagee and some unsecured creditors.

The debtor is insolvent and its serious financial difficulties are of some years' standing. The first mortgage on the apartment house to which it holds title is for $2,650,000.00 and is of the kind known as a certificated mortgage which was guaranteed as to the payment of principal and interest by the New York Title and Mortgage Company. The certificates are part of such securities to the amount of $24,000,000.00 held by the above-mentioned permanent trustees who are otherwise known as the Series C–2 Trustees. The second mortgage is for the face amount of $300,000.00 and there is admittedly due on it $60,000.00 or $65,000.00. The unsecured indebtedness is approximately $3,000.00. The apartment house is assessed for taxation by the City of New York at

$2,630,000.00 and has a gross rent roll of $360,000.00 per year. The net rent income does not appear.

In August 1933, the Superintendent of Insurance of the State of New York, took possession, as rehabilitator, of the assets and business of the New York Title and Mortgage Company. Following that, the Mortgage Commission of the State of New York, as successor to the Superintendent, proposed a plan under the Schackno Act (Chap. 745 of the New York Laws of 1933, as amended), and the Mortgage Commission Act (Chap. 19 of the New York Laws of 1935) for the appointment of permanent trustees for the Series C-2 issue. This plan was approved by the state court on Jan. 15, 1936, and on April 6, in the same year, the court appointed Messrs. Frank L. Weil, William E. Russell and Raymond J. Scully such trustees. They have since been acting as such and are the appellees here.

Among the assets which came into their possession were the bond and mortgage of the debtor which have previously been referred to as the first mortgage on the apartment house. There were arrears of $255,990.00 in interest and of $212,000.00 in principal. The debtor proposed to the trustees that the amount of the interest payments overdue be compromised; future amortization of the principal sum and the payment of the part in arrears be waived; the maturity date of the mortgage extended; and the interest rate reduced. The trustees approved and applied to the state court for permission to accept the debtor's offer. That permission was granted on Aug. 7,

1936 and an extension agreement pursuant to the proposal was entered into. The maturity date of the mortgage was thereby extended to July 31, 1941 upon condition that the debtor pay interest at the rate of 4½% for two years beginning Aug. 1, 1936; at the rate of 4¾% for two years thereafter; and at the rate of 5% for the balance of the term.

The debtor made the payments as agreed with the exception of the taxes due April 1, 1940 and the interest due May 1, 1940 and later cured both those defaults. Before any default, the debtor had had some negotiations with the trustees in respect to a modification of the extension agreement which finally took the form of an offer by the debtor to buy the mortgage for $1,700,000.00 payable within ninety days partly in cash and the remainder in Series C-2 certificates. The trustees sought leave of the state court to accept this offer and it was granted on July 16, 1940. The debtor then presented evidence that the mortgaged property was worth only $1,700,000.00 and it is evident that this valuation was accepted as fair and reasonable. The offer was duly accepted but the debtor did not perform. On Oct. 1, 1940 it defaulted in the payment of taxes then due. On Nov. 1, 1940 it defaulted in the payment of interest and then notified the trustees that it was unable to purchase the mortgage as agreed. The debtor then assigned the rents to the trustees and they appointed its president agent to manage the property. Following that the debtor made another offer to buy the mortgage and informal conferences were had with the judge in charge of the proceedings in the state

court in respect to it. It was not altogether satisfactory to the trustees and before any formal action was taken on it the judge died. The debtor urged the trustees to present the matter for approval to the successor judge who declined to consider it otherwise but the trustees were unwilling to accept the offer and so took no steps to obtain leave to do so.

After the rents were assigned to the trustees and the president of the debtor acted as managing agent of the property the carrying charges were not earned and the amount in arrears when the rents were assigned had been increased during the period from Nov. 1, 1940 to May 31, 1941 to the extent of $5,902.80 making them as of June 1, 1941 $86,724.80.

With affairs in that situation the trustees removed the managing agent as of June 16, 1941 and notified the debtor of their intention to foreclose the mortgage in the state court. There has apparently been no accounting by the managing agent for the period he acted as such in June. Following the removal of the managing agent the petition for reorganization was filed in the district court.

The trustees moved to dismiss the petition as not filed in good faith for several reasons upon which they still rely. One of them was and is that "the prior proceedings in the Supreme Court of the State of New York will best subserve the interests of creditors and stockholders." The district judge after consideration reached that conclusion. This was beyond question an ade-

quate legal ground for the dismissal for lack of filing in good faith under § 141 since it falls precisely within § 146 (4) of the Bankruptcy Act and if the proof warranted the conclusion it will be unnecessary to consider any other ground for dismissal.

We think the facts well support the judge's conclusion. Though there might be a reorganization under Chap. X of the Bankruptcy Act, the value of the debtor's property is so small compared to the amount due on the first mortgage that under *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, only the certificate holders represented by the appellee trustees could have any equity to be preserved. See also, *Consolidated Rock Products Company* v. *Dubois*, 312 U. S. 510. There is nothing to indicate that their interests would, or could, be better protected in the district court. There would be increased expense and delay without any compensating advantages. And it would be inequitable to subject the certificate holders to such expense in time and money when their security, already inadequate, is being well applied to subserve their best interests in the prior state court proceedings. See, *Chapman Bros. Co.* v. *Security-First National Bank*, 111 F. (2) 86. At least, the district judge so decided and that determination is final unless clearly shown to be wrong. *Tennessee Publishing Co.* v. *American National Bank*, 299 U. S. 18; *Wayne United Gas Co.* v. *Owens-Illinois Glass Co.*, 91 F. (2) 827.

Affirmed.

CLARK, *Circuit Judge* (dissenting):

Prior to this case I had been called on but once to participate in the conflict which appears to have developed in this Court between bankruptcy reorganization and state Schackno Act proceedings with regard to concerns engaged in the certificated mortgage business in New York. *In re Blinrig Realty Corp., supra.* There I overcame my doubts as to our emerging law because of the weakness on the facts of the case presented; indeed, we were told in argument that the district court had already dismissed the petition, notwithstanding its original approval. Now we come to another case which I find far from reassuring; and I may say the same as to *In the Matter of Marine Harbor Properties, Inc.*, 2 Cir., —— F. 2d ——. Compare Judge Frank's powerful dissent in the latter case, as well as Judge Bright's decision, D. C. S. D. N. Y., 41 F. Supp. 814, which was reversed; also the law-review criticisms, Siegel, *Chapter X or Schackno Act Proceedings*, 20 Corn. L. Q. 56–73; 18 N. Y. U. L. Q. Rev. 399, 418. I cannot avoid the conviction that we are substituting an inadequate state proceeding for the carefully safeguarded proceedings in reorganization devised by Congress for cases such as this, where the public interest may be protected by the public agency of the Securities and Exchange Commission. And this, it seems to me, is as practically undesirable as it is legally unjustified.

Here we have strikingly illustrated the difficulties of our present approach. Perhaps foreclosure is the best way for all, but we have no real evidence on the point save for the affidavits

of the appearing parties. And these show that the trustees are now acting as dogs in the manger; for they will not present the debtor's revised plan to the state court, and that appears to be the only way it can get there. Though we cannot be sure without testimony, we can conclude that in the present state of the real-estate market, a sale, even at a reduced price, might easily prove to the best interests of all, including the certificate holders. In other words, the matter ought to be before a court for decision, not left solely to the not wholly disinterested trustees.

The stress placed here upon the district judge's finding seems to me not to dispose of the problem. He made no investigation; he had before him only the affidavits now before us. And his finding is most general, merely that the trustees' defenses, formally pleaded, "are sufficient in law and sustained by the proof." Moreover, his opinion shows that he relied on our previous decisions, and was unduly concerned—as I believe we have been—in the activities of the debtor and how it may have estopped itself. This, I believe, was the initial error in *Brooklyn Trust Co.* v. *Rembaugh, supra,* since repeated in the other decisions. For the statute here pertinent, authorizing dismissal of the reorganization petition when it appears "that the interests of creditors and stockholders would be best subserved" in the prior state proceeding, Bankruptcy Act, § 146 (4), 11 U. S. C. A. § 546 (4), requires a definite finding as to the interests of *creditors and stockholders,* not of the debtor. I think we should limit our former precedents to make it clear that the judge must con-

duct the investigation thus so clearly required (wherein, too, the assistance of the Securities and Exchange Commission could be sought and might well prove invaluable), and that we should take the first step thereto in a case such as this, where the facts already disclosed seem to call so clearly for a more searching inquiry. I would reverse for a hearing on the facts.

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